

# **INDIVIDUAL CONTROL OF PENSION FUNDS, PROVIDING FOR RETIREMENT SECURITY**

## **Introduction**

At the dawn of the 21<sup>st</sup> century, America is experiencing both increased mobility in its workers and an aging population. Both of these factors are having an impact on attitudes toward retirement plans.

In the decade from 2010 to 2020, the population over the age of 65 is expected to increase to over 13 million, and to soar to over 15 million in the decade from 2020 to 2030.<sup>1</sup> The number of individuals in the United States over 85 will also swell as the baby boomers begin to retire in 2010. In 1990, the percentage of the U.S. population over 85 years of age accounted for only 1.3 percent of the entire population, while in the year 2030 those over 85 years of age will account for 2.7 percent of the population or 8.1 million people.<sup>2</sup> These individuals will depend on retirement programs for an extended period of time and require an increased amount of savings to maintain a decent standard of living.

At the same time the number of elderly is expanding rapidly, the growth of the population between 20 and 64 years of age will stagnate.<sup>3</sup> After an increase between 13 and 20 million each decade since 1970, the number of individuals between the ages of 20 and 64 is expected to grow by only 7 million between 2010 and 2020 and actually decrease by 700,000 between 2020 and 2030.<sup>4</sup> This decrease will cause a declining ratio of workers to non-workers.

Changing work arrangements challenge existing retirement programs. In today's mobile environment, workers change jobs several times before retirement. Other workers are taking advantage of new opportunities as temporary employees or independent contractors. As a result, workers are increasingly demanding flexible retirement options that offer some assurance of accumulating substantial assets for retirement.<sup>5</sup>

Since the establishment of the Tax Equity and Responsibility Act in 1982, federal government policy has hampered employers in their efforts to offer their employees plans that can provide sufficient retirement income. Prior to 1982, the federal government promoted retirement savings by liberalizing the tax treatment of individual and employer-based savings plans. This produced long-term national savings but reduced current revenues to the federal government. As the federal deficit soared, policy changed to produce additional revenue at the cost of individual and employer-based retirement plans. From 1982 to 1994, a number of policy initiatives reduced the amount that could be contributed to or paid from tax-qualified retirement plans.<sup>6</sup> As a consequence, plan expansion has been curtailed and employers question the feasibility of providing retirement plans for employees.<sup>7</sup>

## **Current Retirement Plans**

Under a defined benefit pension plan, workers are promised a specific amount for each month of their retirement. Contributions toward a retirement fund made by the employer, and often by the employee, make up the investment pool, which is invested by the employer to pay for the promised benefits. Usually the benefits are subject to a vesting requirement, which mandates that the worker remain under the same employer for a certain number of years to receive the benefits.

Under a defined contribution pension plan, the employer contributes a specified percentage of the worker's salary into an individual investment account. The worker controls the investment of the funds and chooses an investment plan from a list of investment options that have been pre-selected by the plan sponsor. This plan usually does not encompass a vesting requirement and the employer's contributions immediately, or within a relatively short period of time, become property of the worker. The pension benefits equal the accrued value of the invested funds.

Through the enactment of the Employee Retirement Security Act of 1974, Congress established IRAs to provide workers who are not participating in employment-based retirement plans an opportunity to save for retirement on a tax-deferred basis. The maximum contribution allowed to an IRA is \$2,000 per year. Taxes on IRAs depend on the eligibility of the individual.<sup>8</sup>

Salary reduction plans allow workers to save their money for retirement on the same tax-deferred basis enjoyed by the fully deductible IRA contributions. A salary reduction plan is a defined contribution plan that allows participants to have portions of their salary contributed to a retirement account on their behalf by their employer, who in many cases offers a matching portion to the account for the employee. These cash or deferred arrangement plans include the 401(k) plan for the profit sector of private industry, 403(b) plan for the nonprofit sector of private industry, and the 457 plan for state and local governments.<sup>9</sup>

## **Salary Reduction Plans v. IRAs**

Salary reduction plans offer a financial advantage over IRAs because the amount that can be contributed on a tax-deductible basis is much higher. The salary reduction plans have another financial advantage in that the maximum contribution is indexed for inflation, while the IRA maximum is not. The plan sponsor acts as a fiduciary filter through researching investment options for the participant and offering a variety of sound investment options, and many employers even offer to match the employee contributes to their fund. IRAs, on the other hand, do offer participants more access to their money because funds can be withdrawn at any time subject to a tax penalty.<sup>10</sup>

## **Defined Benefit v. Defined Contribution Plans**

Immediate vesting is an essential part of the defined contribution plan and would benefit employees who plan to change jobs throughout their career. This allows the employer's contributions to the individual account to become the property of the employee upon payment by the employer. In California, 70 percent of state and local workers fail to receive their employer's contributions because they fail to stay with the same employer for the designated ten year vesting requirement of public sector pension plans.<sup>11</sup>

Some small businesses cannot afford to offer a defined benefit plan; others respond to increased costs and complex statutory and regulatory requirements by terminating their plans. The total number of participants in defined benefit plans rose from 33 million in 1975 to 41 million in 1988, but dropped to 39 million by 1990.<sup>12</sup> During the same time period the number of participants in defined contribution plans increased from 12 million in 1975 to 38 million in 1990.<sup>13</sup> Defined benefit plans are vulnerable to demographic changes, hinder worker mobility, and require long-term vesting.

## **Legislation for Defined Contribution Plans**

Michigan Governor John Engler introduced a defined contribution reform plan for state workers in 1996. The state legislature passed the plan that started a defined contribution plan for all new employees of the state and gave current employees a choice between the existing defined benefit plan or the new defined contribution plan. The plan includes a vesting feature where the employer contributions are vested 50 percent after two years, 75 percent after three years, and 100 percent after four years.<sup>14</sup> If the employee leaves the job before the vesting begins, the employer contribution must be returned.

The plan enacted by Michigan helps both workers and the state. The Department of Management and Budget estimates that Michigan will save almost \$100 million in the first year alone under this plan. In addition, the 45 percent of state employees and 65 percent of public school employees who received no benefits under the old plan because they cease employment too early will now be able to benefit under the new system after only two years.<sup>15</sup>

In 1996, California Assemblyman Howard Kaloogian offered a similar plan, which would have authorized state and local employers to offer a defined contribution plan as an alternative to their defined benefit plan. The bill aimed to extend benefits to 75 percent of public employees who receive no benefits because they leave the system before taking a retirement benefit. This plan passed the Assembly but was opposed in the state senate; however, both houses passed a narrower bill that provided a defined contribution plan for state universities and colleges. The California schools argued successfully that it would help recruit top professors if the professors knew they would receive a pension benefit even if they left after a few years.

A number of states have established defined contribution plans for local workers, and options for employees in higher education to enter a defined contribution plan such as the one in California are becoming increasingly popular. Studies of expanding the option to all state employees are occurring in ten different states and legislation to expand defined contribution plans is under consideration in 20 states.<sup>16</sup>

## Findings and Recommendations

Today's workers, who change jobs and careers more than ever before, require flexible and portable benefits laws.

- Congress should revise laws to allow benefits to be tied to either the employer or employee.
- Congress should investigate providing a legal option for employees to carry vested benefits from job to job for the duration of their careers.

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<sup>1</sup> OASDI *Trustees Report*, p.147.

<sup>2</sup> *Aging America, Trends and Projections*, 1991 Edition; U.S. Senate Special Committee on Aging, American Association of Retired Persons, Federal Council on the Aging, & U.S. Administration on Aging, p. 7.

<sup>3</sup> The ERISA Industry Committee. A WHITE PAPER ON EMERGING PENSION ISSUES. (July 1996)

<sup>4</sup> OASDI *Trustees Report*, p. 147

<sup>5</sup> The ERISA Industry Committee, GETTING THE JOB DONE: A WHITE PAPER ON EMERGING PENSION ISSUES (July 1996).

<sup>6</sup> Id. Each of these laws contained provisions that reduced amounts that could be contributed to or paid to tax-qualified retirement plans: The Tax Equity and Fiscal Responsibility Act of 1982, The Deficit Reduction Act of 1984, The Consolidated Omnibus Budget Reconciliation Act of 1985, The Tax Reform Act of 1986, The Omnibus Budget Reconciliation Act of 1987, The Omnibus Budget Reconciliation Act of 1989, The Omnibus Budget Reconciliation Act of 1990, The Omnibus Budget Reconciliation Act of 1993, The Uruguay Round Agreements Act (GATT '94).

<sup>7</sup> Id.

<sup>8</sup> *Facts about IRAs*, The American Savings Education Council." [www.asec.org/irafact.htm](http://www.asec.org/irafact.htm)

<sup>9</sup> *Definitions of Savings and Retirement Terms*. American Savings Education Council. [www.asec.org/terms.htm](http://www.asec.org/terms.htm)

<sup>10</sup> Testimony of Paul Yakoboski. The penalty is generally a 10 percent tax in addition to income tax.

<sup>11</sup> Ferrara, Peter. *Pension Liberation: A Proactive Solution for the Nation's Public Pension System*. AMERICAN LEGISLATIVE EXCHANGE COMMISSION, August 1997.

<sup>12</sup> EBRI DATABOOK, pp. 139-40 and 144.

<sup>13</sup> Id.

<sup>14</sup> Ferrara, Peter. *Pension Liberation: A Proactive Solution for the Nation's Public Pension System*.

<sup>15</sup> Id.

<sup>16</sup> Id.